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ORIGIN EUR-03

INFO OCT-01 ISO-00 /004 R

66618

DRAFTED BY EUR/RPE:GEWOLFE:RP

APPROVED BY EUR/RPE:ACALBRECHT

EUR/RPE:DLAMB

EUR/NE:NACHILLES

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R 312116Z OCT 75

FM SECSTATE WASHDC

INFO USMISSION NATO 0000

C O N F I D E N T I A L STATE 258607

FOLLOWING REPEAT LONDON 16478 ACTION SECSTATE INFO BERN THE HAGUE
STOCKHOLM MADRID COPENHAGEN OSLO DUBLIN WELLINGTON TOKYO OTTAWA
VIENNA LUXEMBOURG BRUSSELS BONN ROME ANKARA EC-BRUSSELS
OECD PARIS EDINBURGH 28 OCT

QUOTE

C O N F I D E N T I A L LONDON 16478

E.O. 11652: GDS

TAGS: ENRG UK

SUBJECT: NORTH SEA OIL DEVELOPMENT: AN OVERALL
ASSESSMENT

REF: LONDON A-281; EDINBURG 223

1. SUMMARY: THIS MESSAGE ASSESSES THE CURRENT STATUS
OF BRITISH NORTH SEA OIL DEVELOPMENT. PROSPECTS FOR THE
FUTURE ARE SUMMARIZED IN THE LAST PARAGRAPH. END SUMMARY

2. BETWEEN THE UK AND NORWEGIAN SECTORS OF THE NORTH
SEA, POTENTIAL RECOVERABLE RESERVES TOTAL SOME 30-40
BILLION BARRELS OF OIL AND POSSIBLY 100 TRILLION CUBIC
FEET OF NATURAL GAS. PRODUCTION POTENTIAL BY THE
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EARLY 1980S IS IN THE RANGE OF 4 TO 5 MILLION BARRELS A
DAY OF OIL AND 12 BILLION CUBIC FEET A DAY OF GAS. WHILE
EVEN PARTIAL REALIZATION OF THIS POTENTIAL WILL HAVE
GREAT IMPACT AND IMPORTANCE FOR THE BRITISH AND

NORWEGIAN ECONOMIES, ONLY FULL DEVELOPMENT CAN AFFECT THE ENERGY STRATEGIES OF WESTERN EUROPE IN PARTICULAR AND THE IEA MEMBER STATES MORE BROADLY IN A TRULY SIGNIFICANT WAY. THOUGH THIS MESSAGE WILL FOCUS ON THE BRITISH SECTOR OF THE NORTH SEA, THERE IS A MEASURE OF PSYCHOLOGICAL AS WELL AS PHYSICAL INTERACTION BETWEEN DEVELOPMENT IN THE UK AND NORWEGIAN SECTORS WHICH SHOULD NOT BE OVERLOOKED.

3. IN THE EARLY DAYS OF THE NORTH SEA OIL PLAY, THE ATMOSPHERE, TONE AND PACE OF ACTIVITY WAS HECTIC AND HEADILY OPTIMISTIC. LARGE AND SMALL COMPANIES, MANY OF THE LATTER WITH SPECULATIVE FEVER BUT NO KNOWLEDGE OR EXPERTISE IN OIL, HOSTLED EACH OTHER IN THE RUSH TO OBTAIN NEW LICENSES. DRILLING RIGS AND PRODUCTION EQUIPMENT WERE DRAWN FROM OUTLYING AREAS OF INTERNATIONAL OIL INDUSTRY OPERATIONS IN ORDER TO COPE WITH NORTH SEA NEEDS. THE PROSPECTIVE PROFIT PICTURE LOOKED ROSY TO THE COMPANIES AND THE GLOW EXTENDED TO GOVERNMENT, WHICH WAS COUNTING ON A "LAUNCH PAD" FOR GROWTH OF THE GENERAL ECONOMY, NEW JOBS TO HELP FIGHT UNEMPLOYMENT (ESPECIALLY IN SCOTLAND) AND A FINISH TO BALANCE OF PAYMENTS PROBLEMS.

4. WITHIN THE PAST TWO YEARS THERE HAS BEEN A GRADUAL EROSION IN THE LEVEL OF CONFIDENCE DISPLAYED BY THE OIL INDUSTRY AND FINANCIAL INSTITUTIONS AND AN END TO THE BONANZA PSYCHOLOGY (AND SOME OF THE SMALLER SPECULATIVE MINNOWS). INSTEAD OF VIEWING NORTH SEA BENEFITS AS A LAUNCH PAD, GOVERNMENT SLOWLY EVOLVED A "HOLD-ON-FOR-DEAR-LIFE-PRESERVER" MENTALITY UNDER THE PRESSURE OF INTERNAL AND EXTERNAL ECONOMIC AND POLITICAL FORCES. DEVELOPMENT TIMETABLES HAVE MET WITH ALARMING SLIPPAGES WHILE ACTUAL COSTS AND COST ESTIMATES HAVE BEEN REVISED DRASTICALLY UPWARD. THE TECHNOLOGICAL DIFFICULTIES OF SCALING UP OR DEVELOPING NEW STRUCTURES AND EQUIPMENT TO MEET THE HOSTILE NORTH SEA ENVIRONMENT ALSO HAVE BEEN FAR

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GREATER THAN INITIALLY EXPECTED. SCOTTISH NATIONALISM AND LEFT-WING LABOR SENTIMENT FOR A GO-SLOW, STATE CONTROLLED APPROACH HAVE MADE THEIR MARK. DESPITE LIP SERVICE TO THE CONTRARY, THERE ARE SERIOUS DOUBTS THAT MANY IN IMPORTANT GOVERNMENT POSITIONS ARE STILL INTERESTED PRIMARILY IN ATTRACTING MORE FOREIGN INVESTMENT AND PROMOTING RAPID DEVELOPMENT. RATHER, WITH SELF-SUFFICIENCY BY 1980-81 IN SIGHT, CONCERN OVER CONSERVATION THROUGH DEPLETION CONTROLS, SURFACING OF IDEOLOGICAL OR PRAGMATIC SUSPICION OF OIL INDUSTRY MOTIVES AND ACTIONS, AND A GROWING INSISTENCE ON STRICTER NON-FISCAL DEVELOPMENT CONTROLS HAVE COME TO THE FORE.

5. EXPECTATIONS FOR FUTURE EXPLORATION AND DEVELOPMENT ACTIVITY HAVE BEEN TRIMMED BOTH BY THE INDUSTRY, IN STRIDENT PUBLIC DECLARATIONS, AND GOVERNMENT, IN PRIVATE COUNSEL. AS PREDICTED EARLIER, THIS YEAR'S EXPLORATION DRILLING HAS REACHED A PLATEAU, IF NOT A PEAK, INSTEAD OF SHOWING A SUBSTANTIAL 50 PERCENT INCREASE. LITTLE IF ANY PUBLICITY HAS BEEN GIVEN TO THE GRIM FACT THAT OUT OF MORE THAN TWENTY DISCOVERIES WITHIN THE PAST YEAR, ONLY ONE FIND HAS BEEN DECLARED "COMMERCIAL" BY AN OIL COMPANY.

6. FINANCING HAS CONTINUED TO BE A STUMBLING BLOCK AS BANKS REJECT PROJECT FINANCING AND INSIST ON SOLID BALANCE-SHEET BACKUP FOR DEVELOPMENT LOANS. ONLY THE LARGER COMPANIES WITH STRONG CREDIT RATINGS CAN RELY ON LESS THAN DETAILED SCRUTINY OF A PROPOSED BORROWING. BANKERS HAVE BEEN CONCERNED BY THE SUBSTANTIAL TECHNICAL RISKS ENCOUNTERED (WHICH THEY NOW EXPECT THE OIL COMPANIES TO SHOULDER), THE SKYROCKETING COSTS (WHICH NOW AT LEAST APPEAR TO HAVE STABILIZED) AND THE POLITICAL UNCERTAINTIES ABOUT HMG OFFSHORE POLICIES AS CONTAINED IN THE PROPOSED PETROLEUM AND SUBMARINE PIPELINES BILL SETTING UP A BRITISH NATIONAL OIL COMPANY AND IMPOSING NON-FISCAL CONTROLS ON DEVELOPMENT AND PRODUCTION, AND STILL VAGUE PROPOSALS FOR MAJORITY STATE PARTICIPATION. INCREASINGLY, THE BANKERS ALSO ARE LOOKING FOR STRONG UNDER-TAINGS, PREFERABLY IN THE FORM OF DIRECT GUARANTEES BY GOVERNMENT. ONE POSSIBLE BRIGHT SPOT, FOR BANKERS AT LEAST, IS THAT 900 MILLION POUNDS STERLING IS LIKELY TO BE CONFIDENTIAL

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BE MADE AVAILABLE TO THE BRITISH NATIONAL OIL CORPORATION TO ENABLE IT TO ASSUME, UNDER WHATEVER PARTICIPATION FORMULA IS EVENTUALLY APPROVED, UP TO 51 PERCENT OF FUTURE DEVELOPMENT COSTS OF INDIVIDUAL FIELDS, THEREBY EASING THE FINANCIAL BURDEN PLACED ON EXISTING EQUITY AND DEBT HOLDERS. ANOTHER MEASURE INDIRECTLY PROTECTIVE OF BANKER INTERESTS WAS THE PROVISION OF THE OIL TAXATION ACT ALLOWING FOR DISCRETIONARY EXEMPTION FROM PETROLEUM REVENUE TAXES SUFFICIENT TO ASSURE A MINIMUM RATE OF RETURN AND CASH FLOW FROM NORTH SEA INVESTMENT IN MARGINAL FIELDS. BANKERS AS WELL AS SOME OIL COMPANIES STAND TO BENEFIT FROM SUCH ATTEMPTS TO PROVIDE A BASIC SUPPORT LEVEL FOR NORTH SEA PROJECTS. NONETHELESS, THE BULK OF FINANCING UP UNTIL NOW HAS BEEN PROVIDED BY A HANDFUL OF BANKS, MOSTLY AMERICAN, WHICH WOULD PREFER TO BRING IN GREATER DIVERSITY OF FUNDING SOURCES FOR ANY FUTURE FIELD FINANCING. THEY ALSO CLAIM THAT GOVERNMENT PARTICIPATION AND POSSIBLE LIMITATION ON PROFIT WILL WORK AGAINST DEVELOPMENT OF FIELDS WHICH COULD BE CLASSIFIED AS HIGH RISK/HIGH REWARD. IN BRIEF, ADDITIONAL SUBSTANTIAL NORTH SEA FINANCING IS LIKELY TO OCCUR ONLY AFTER HMG'S INTENTIONS ON PARTICIPATION ARE MADE CRYSTAL CLEAR.

7. ON-SHORE FACILITIES WHICH WERE HURRIEDLY BUILT TO PROVIDE EQUIPMENT AND SERVICES FOR OFFSHORE EXPLORATION AND DEVELOPMENT PROGRAMS HAVE BEGUN TO BE HIT BY THE SLOWDOWN IN DRILLING. A NUMBER OF PLATFORM CONSTRUCTION SITES HAVE FOUND EMPTY ORDER BOOKS AS NEW INVESTMENT HAS DRIED UP, MUCH TO THE DISMAY AND EMBARRASSMENT OF HMG WHICH, ACTING PARTLY ON INDUSTRY ESTIMATES AND PARTLY ON THE BASIS OF ITS OWN STUDIES, TOOK POWERS TO NATIONALIZE POTENTIAL CONSTRUCTION SITES OVER OBJECTIONS OF LOCAL SCOTTISH AND ENVIRONMENTALIST GROUPS. GREATER UTILIZATION OF EXISTING AND PLANNED ON-SHORE FACILITIES, WHICH ONLY A YEAR AGO WAS HELD TO CONTRIBUTE TO INFLATION AND LABOR SHORTAGES, NOW COULD BRING POSITIVE BENEFITS TO A HARD-PRESSED GOVERNMENT AT A TIME OF DEEPENING RECESSION AND UNEMPLOYMENT. THIS IS ONE PROSPECTIVE SOURCE OF SCOTTISH SUPPORT FOR PUSHING AHEAD AS PLANNED WITH RAPID NORTH SEA DEVELOPMENT.

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8. THERE ARE OTHER PROSPECTIVELY BRIGHT SPOTS IN THIS LESS THAN CHEERFUL PICTURE. THE PENDULUM SEEMINGLY HAS BEGUN TO SWING BACK FROM THE RETROGRADE OF THE PAST 18 MONTHS TOWARD A MIDDLE GROUND. A NUMBER OF ECONOMIC FACTS OF LIFE AS WELL AS POLITICAL LESSONS APPEAR IN THE PROCESS OF BEING ABSORBED SLOWLY INTO THE COLLECTIVE CONSCIOUSNESS OF GOVERNMENT, INDUSTRY, LENDING INSTITUTIONS, PARLIAMENT, PRESS, SCOTLAND AND PUBLIC OPINION. AS THE SELLER'S MARKET FOR SUPPLIES, EQUIPMENT AND SERVICES, BOTH BRITISH AND WORLD-WIDE, HAS MODERATED, SO HAS THE DRASTIC INFLATION IN COSTS. OVER TIME, THIS SHOULD BRING RENEWED STABILITY TO INDUSTRY AND FINANCIAL PLANNING FOR EXPLORATION AND ESPECIALLY DEVELOPMENT PROGRAMMING. MOREOVER, GOVERNMENT IS GIVING CLEARER SIGNS IN TAX, NON-FISCAL CONTROL, PROCUREMENT AND PARTICIPATION NEGOTIATIONS THAT IT IS WILLING AND ABLE TO SLOWLY, CAREFULLY, AND QUIETLY OUTMANEUVER OR FIGHT OFF EXTREMIST POLITICAL OR ECONOMIC PRESSURES. WITH ITS BACK ALMOST LITERALLY AGAINST AN ECONOMIC WALL, HMG HAS TAKEN PAINS TO CONSULT AND THEN COMPROMISE WITH INDUSTRY BASED ON REALITY RATHER THAN IDEOLOGY. PERHAPS THE ULTIMATE TEST CASE WILL BE WHETHER OR NOT IT CAN SUCCESSFULLY FIND A SATISFACTORY COMPROMISE ON THE LABOR PARTY MANIFESTO'S COMMITMENT TO MAJORITY STATE PARTICIPATION. SHOULD THIS BE POSSIBLE, THE PROPOSED FIFTH ROUND OF LICENSES SCHEDULED FOR SOME TIME IN 1976 COULD TURN OUT TO BE COMPARATIVELY SUCCESSFUL, DESPITE THE DISAPPOINTING GEOLOGICAL INDICATIONS FOR THE AREAS WEST OF THE SHETLANDS, THE CELTIC SEA AND THE WESTERN APPROACHES.

9. WHAT ARE THE PROSPECTS FOR THE FUTURE? FIRST, IT IS

LIKELY THAT DESPITE DELAYS, HIGHER COSTS, TECHNICAL PROBLEMS, ETC., BRITAIN WILL REACH VIRTUALLY SELF-SUFFICIENCY IN OIL AND GAS BY THE EARLY 1980S (APPROXIMATELY 2.2 TO 2.4 MILLION BARRELS A DAY). BARRING ADOPTION OF NEAR-CONFISCATORY HMG POLICIES, FIELD DEVELOPMENT ALREADY BEGUN OR PLANNED WILL CONTINUE. EVEN SHARPLY LOWER OPEC CRUDE PRICES WOULD NOT STOP NORTH SEA DEVELOPMENT ALREADY BEGUN SINCE HMG WOULD FIND IT IN ITS INTEREST TO "FORGIVE" PETROLEUM REVENUE TAX, ROYALTY OR EVEN CORPORATION TAX PAYMENTS IN ORDER TO OBTAIN BALANCE OF PAYMENTS BENEFITS

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FROM PRODUCING NORTH SEA CRUDE RATHER THAN IMPORT OPEC CRUDE. SECOND, UNLESS FURTHER EXPLORATION AND ESPECIALLY NEW DEVELOPMENT ACTIVITY RESUMES, BRITAIN'S PERIOD OF SELF-SUFFICIENCY COULD BE SHORT-LIVED, POSSIBLY A PERIOD OF FIVE TO EIGHT YEARS AFTER WHICH THE PRODUCTION PLATEAU WOULD SLOWLY TAIL OFF. IT IS A GOOD BET, HOWEVER, THAT HMG HAS HEARD, WILL UNDERSTAND AND ACT IN ITS OWN GOOD TIME ON THE MESSAGE OF THE OIL INDUSTRY AND FINANCIAL INSTITUTIONS: NO SATISFACTORY RESOLUTION OF OUTSTANDING ISSUES, NO MORE INVESTMENT IN NEW NORTH SEA PROJECTS. THIRD, IT IS UNLIKELY THAT THE NORTH SEA WILL EVER AGAIN GENERATE THE ONANZAN ENTHUSIASM OF EARLIER YEARS. EXCESSIVE OPTIMISM BY INDUSTRY WHICH UNDERESTIMATED THE ECONOMIC, TECHNICAL AND POLITICAL RISKS IS NOT APT TO RETURN. ON THE OTHER HAND, NO BRITISH GOVERNMENT, WHETHER LABOR OR CONSERVATIVE, COULD OR WOULD WANT TO RECREATE THE CLIMATE OR ATMOSPHERE OF BOOM PSYCHOLOGY ONCE NORTH SEA WILL HAVE BECOME A PROVEN, MATURE OIL PROVINCE. FINALLY, THE BEST GUESS IS THAT BRITISH NORTH SEA POTENTIAL WILL BE REALIZED TO AN EXTENT AND IN A TIME SCALE WHICH FALLS SOMEWHERE IN BETWEEN THE "LITTLE BRITAIN" STRATEGY OF SOME AND THE BROADER WEST EUROPEAN OR IEA STRATEGY FAVORED BY OTHERS.

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Message Attributes

Automatic Decaptioning: X
Capture Date: 26 AUG 1999
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: PETROLEUM INDUSTRY, PETROLEUM PRODUCTION, NORTH SEA, INTELLIGENCE ASSESSMENTS
Control Number: n/a
Copy: SINGLE
Draft Date: 31 OCT 1975
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: SmithRJ
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1975STATE258607
Document Source: ADS
Document Unique ID: 00
Drafter: EUR/RPE:GEWOLFE:RP
Enclosure: n/a
Executive Order: 11652 GDS
Errors: n/a
Film Number: D750380-0515
From: STATE
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1975/newtext/t197510102/baaaaczm.tel
Line Count: 259
Locator: TEXT ON-LINE, TEXT ON MICROFILM
Office: ORIGIN EUR
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 5
Previous Channel Indicators:
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: n/a
Review Action: RELEASED, APPROVED
Review Authority: SmithRJ
Review Comment: n/a
Review Content Flags:
Review Date: 16 APR 2003
Review Event:
Review Exemptions: n/a
Review History: RELEASED <16 APR 2003 by BoyleJA>; APPROVED <02 OCT 2003 by SmithRJ>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
06 JUL 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: n/a
TAGS: ENRG, UK
To: n/a INFO NATO
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 06 JUL 2006